

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
DAVIES LAKE HOTEL, INC. :
for Redetermination of a Deficiency or for :
Refund of Corporation Franchise Tax under :
Article 9-A of the Tax Law for the Years 1972 :
and 1975 through 1981. :

In the Matter of the Petition :
of :
ESTATE OF ADOLPH MILICH :
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1972 through 1975. :

DETERMINATION

In the Matter of the Petition :
of :
ADOLPH MILICH, JR. :
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax under Article 22 :
of the Tax Law for the Years 1978 through 1981. :

In the Matter of the Petition :
of :
ROBERT AND BARBARA MILICH :
for Redetermination of a Deficiency or for :
Refund of Personal Income Tax and Unincorporated :
Business Tax under Articles 22 and 23 of the :
Tax Law for the Years 1978 through 1981. :

Petitioner Davies Lake Hotel, Inc., 25 New Valley Road, New City, New York 10956,
filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under
Article 9-A of the Tax Law for the years 1972 and 1975 through 1981 (File No. 802595).

Petitioner Estate of Adolph Milich, c/o Robert Milich, 11 Milich Lane, New City, New York 10956, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1972 through 1975 (File No. 802598).

Petitioner Adolph Milich, Jr., 29 New Valley Road, New City, New York 10956, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1978 through 1981 (File No. 802597).

Petitioners Robert and Barbara Milich, 11 Milich Lane, New City, New York 10956, filed a petition for redetermination of a deficiency or for refund of personal income tax and unincorporated business tax under Articles 22 and 23 of the Tax Law for the years 1978 through 1981 (File No. 802599).

A consolidated hearing was held before Robert F. Mulligan, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on December 10, 1987 at 1:15 P.M. Petitioners appeared by Paul F. Onderdonk, C.P.A. The Audit Division appeared by William F. Collins, Esq. (Lawrence A. Newman, Esq., of counsel).

ISSUE

Whether petitioner Davies Lake Hotel, Inc. is entitled to net operating loss deductions offsetting income adjustments determined upon audit.

FINDINGS OF FACT

1. The deficiencies at issue arise from an audit of the corporate petitioner, Davies Lake Hotel, Inc. ("the corporation"). A sales tax audit of the corporation resulted in a determination of additional sales and use taxes due. (The sales and use taxes due are not at issue and appear to have been paid.) The matter was then referred for corporation tax and personal income tax audit action.

Davies Lake Hotel, Inc.

2. On June 21, 1985, the Audit Division issued a Statement of Franchise Tax Audit Changes against the corporation stating the following:

Year	<u>1972</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	
Sales		\$167,106.00	\$151,300.00		\$140,653.00
\$111,600.00					
Cost of Goods Sold		44,651.00	40,427.00		30,025.00
38,317.00					
Business Expenses		66,143.00	17,490.00		64,070.00
72,433.00					
Net Income		56,312.00	93,383.00		46,558.00
850.00					
Income Reported	-0-	-0-	-0-	-0-	
Balance		56,312.00	93,383.00		46,558.00

850.00			
Tax Due	5,068.08	8,404.47	4,655.80
250.00			

Year	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	
Sales		\$112,789.00	\$157,344.00		\$115,652.00
\$72,709.00					
Cost of Goods Sold		28,755.00	34,111.00		24,524.00
16,593.00					
Business Expenses		59,809.00	60,313.00		47,833.00
39,901.00					
Net Income		24,225.00	62,920.00		43,295.00
16,215.00					
Income Reported	-0-	-0-	-0-	-0-	
Balance		24,225.00	62,920.00		43,295.00
16,215.00					
Tax Due		2,422.50	6,292.00		4,329.50
1,621.50					

3. On August 2, 1985, the Audit Division issued notices of deficiency to the corporation asserting the following amounts to be due:

<u>Year</u>	<u>Tax</u>	<u>Interest</u>	<u>Charge</u>	<u>Additional</u> <u>Total Due</u>	
1972		\$5,068.08	\$ 7,269.34	\$ 2,660.74	
\$14,998.16					
1975		8,404.47	10,266.15	4,412.34	23,082.96
1976		4,655.80	5,194.18	2,444.30	12,294.28
1977		250.00	252.44	131.25	633.69
1978		2,422.50	2,189.72	1,271.82	5,884.04
1979		6,292.00	5,021.24	3,303.30	14,616.54
1980		4,329.50	2,996.73	2,272.99	9,599.22
1981		1,621.20	849.39	818.73	3,289.32

(The "Additional Charge" items were penalties under Tax Law § 1085[a][1]; [a][2]; [b].)

Estate of Adolph Milich, Deceased

4. A portion of the additional income of the corporation was attributed to the Estate of Adolph Milich as a constructive dividend. A Statement of Audit Changes issued to said petitioner on June 21, 1985 stated, in part, as follows:

Year	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>		
Constructive Dividend		\$18,771.00	\$17,047.00	\$18,620.00	\$31,128.00	
Standard Deduction		(2,000.00)	(2,000.00)	(2,000.00)	(2,000.00)	
Exemption		(650.00)	(650.00)	(650.00)	(650.00)	
Net Adjustment		16,121.00	14,397.00	15,970.00	28,478.00	
Tax Due		996.40	805.73	957.00	2,646.24	

5. On August 8, 1985, a Notice of Deficiency was issued to the Estate of Adolph Milich, deceased, for 1972, 1973, 1974 and 1975 for \$5,405.37 in tax, \$2,837.82 in penalty (Tax Law § 685[a][1]; [a][2]; [b]) and \$7,189.50 in interest, for a total of \$15,432.69.

Adolph Milich, Jr.

6. A portion of the additional income of the corporation was attributed to Adolph Milich, Jr., as a constructive dividend. On June 21, 1985, a Statement of Audit Changes was issued to said petitioner stating, in part, as follows:

Year	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>		
Constructive Dividend		\$12,112.50	\$31,460.00	\$21,648.00		\$
8,108.00						
Statutory Medical Adjustment	-0-	-0-	322.00	-0-		
Net Adjustment		12,112.50	31,460.00	21,970.00		
8,108.00						
Taxable Income Reported		8,188.00	9,402.00	11,033.00		
10,985.00						
Corrected Taxable Income		20,300.50	40,862.00	33,003.00		
19,093.00						
Additional Tax Due		1,104.78	3,872.68	2,657.42		
772.16						

7. The following consents extending the period of limitation upon assessment of personal income and unincorporated business taxes were executed by Adolph Milich, Jr. and Marsha Milich¹:

(a) Consent dated December 13, 1982 extending the period of limitation for the year 1979 to April 15, 1984.

(b) Consent dated January 17, 1984 extending the period of limitation for the years 1979 and 1980 to April 15, 1985.

(c) Consent dated January 15, 1985 extending the period of limitation for the years 1979, 1980 and 1981 to April 15, 1986.

8. On August 8, 1985, the Audit Division issued a Notice of Deficiency to petitioner Adolph Milich, Jr., for the years 1978, 1979, 1980 and 1981 in the amount of \$8,407.04 in tax, \$420.35 in penalty (Tax Law § 685[b]) and \$5,160.56 in interest, for a total of \$13,987.95.

Robert and Barbara Milich

9. A portion of the additional income of the corporation was attributed to Robert Milich as a constructive dividend. On June 21, 1985, a Statement of Audit Changes was issued to Robert

¹It is noted that there is no consent for 1978 in the record. However, petitioners do not claim that assessment for said year is barred by the statute of limitations (see Finding of Fact "20").

and Barbara Milich stating, in part, as follows:

Year	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>		
Constructive Dividend			\$12,112.50	\$31,460.00	\$21,648.00	\$
8,108.00						
Statutory Medical Adjustment		-0-		317.00	314.00	
243.24						
Unreported IRS Audit Change		-0-	-0-	6,475.00	-0-	
Net Adjustment			12,112.50	31,777.00	28,437.00	
8,351.24						
Taxable Income Reported			4,327.00	7,806.00	10,812.00	
9,503.00						
Corrected Taxable Income			16,439.50	39,583.00	39,249.00	
17,854.24						
Additional Tax Due			905.87	3,828.62	3,582.79	
738.97						

10. The following consents extending the period of limitation upon assessment of personal income and unincorporated business taxes were executed by Robert and Barbara Milich²:

(a) Consent dated January 8, 1982 extending the period of limitation for 1979 to April 15, 1984.

(b) Consent dated January 14, 1984 extending the period of limitation for 1979 and 1980 to April 15, 1985.

(c) Consent dated January 29, 1985 extending the period of limitation for 1979, 1980 and 1981 to April 15, 1986.

11. On August 8, 1985, the Audit Division issued a Notice of Deficiency to Robert and Barbara Milich for the years 1978, 1979, 1980 and 1981 in the amount of \$9,056.25 in tax, \$452.81 in penalty (Tax Law § 685[b]) and \$5,479.01 in interest, for a total due of \$14,988.07.

Robert Milich (Unincorporated Business Tax)

12. On June 21, 1985, the Audit Division issued a Statement of Unincorporated Business Tax Audit Changes to Robert Milich for the year 1980 explaining that \$5,812.00 in additional unincorporated business income had been determined based on unreported Federal audit changes, resulting in \$232.67 in additional tax due. On August 8, 1985, the Audit Division issued a Notice of Deficiency for unincorporated business tax for 1980 to Robert Milich for \$232.67 in tax and \$128.67 in interest, for a total of \$361.34. At the hearing, petitioners' representative conceded that this deficiency was correct and it is not at issue herein.

²As was the case with Adolph Milich, Jr. and Marsha Milich (footnote 1), there is no consent for 1978 in the record. Again, there has been no claim that assessment for said year is barred by the statute of limitations (see Finding of Fact "20").

Business Operations of the Corporation

13. The corporation was formed in 1959. The 1971 New York State corporation franchise tax report indicated that its principal business activity was "Bar -- Hotel". The 1973 report indicated "Food Bevg. Rec.". The 1974 report indicated "Lake -- Recreation".

14. Between 1971 and 1975, the corporation was controlled by Adolph Milich, who owned 68 percent of the stock and served as treasurer of the corporation. Adolph Milich died in 1975 at approximately 83 years of age.

15. The corporation's accountant prepared Federal income tax returns and State corporation franchise tax reports for the corporation for the years 1971 through 1976. The State, however, received only the reports for 1971, 1973 and 1974 and petitioners conceded that the reports prepared for 1972, 1975 and 1976 were, for some reason, not filed. The accountant was apparently not retained to prepare reports for years subsequent to 1976 and no reports were filed for those years.

Net Operating Loss Deductions

16. A copy of the corporation's 1971 Federal income tax return showed an operating loss for said year of \$32,050.00. The balance sheet on the return showed negative retained earnings at the beginning of 1971 of \$78,626.00 and penalties of \$713.00, for negative retained earnings (including the 1971 loss) of \$111,389.00. The New York corporation franchise tax report showed a Federal operating loss of \$32,050.00 and a New York loss of \$31,950.00. Petitioners' representative claimed at the hearing that the 1971 New York report contained "a net operating loss carry-forward deduction of \$76,869.00 and it's our position that that operating loss deduction should be included in the calculation of the deficiency for 1972, and to the extent that it is available, for the years 1975 and thereafter."

17. A copy of the corporation's 1973 Federal return shows a loss from operations of \$4,613.00, with negative retained earnings at the beginning of 1973 of \$139,176.00 and negative retained earnings at the end of 1973 of \$143,789.00. A copy of the New York report for 1973 shows a Federal loss of \$4,613.00 with a New York loss of \$4,488.00.

18. A copy of the corporation's 1974 Federal return shows a loss from operations of \$14,199.00 with a balance of negative retained earnings at the beginning of 1974 of \$143,789.00. The total at the end of 1974 was \$157,988.00. A copy of the New York report shows the \$14,199.00 Federal loss and a \$14,050.00 New York loss.

The Tax Appeals Bureau Conference

19. Pursuant to a Tax Appeals Bureau conference, petitioners provided additional substantiation of business expenses which resulted in the following modifications of the aforementioned deficiencies³:

³Modification of deficiencies in tax resulted in modification of penalties. The revised penalties are not shown herein.

(a) Davies Lake Hotel, Inc.

Year	<u>1972</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	
Sales		\$167,106.00	\$151,300.00		\$140,653.00
\$111,600.00					
Cost of Goods Sold		44,651.00	40,427.00		30,025.00
38,317.00					
Business Expenses		88,403.00	68,146.00		67,759.00
74,253.00					
Net Income		34,052.00	42,727.00		42,869.00
(970.00)					
Income Reported	-0-	-0-	-0-	-0-	
Balance		34,052.00	42,727.00		42,869.00 (970.00)
Tax Due ⁴		2,939.68	3,972.70		4,036.90 -0-

Year	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	
Sales		\$112,789.00	\$157,344.00		\$115,652.00
\$72,709.00					
Cost of Goods Sold		28,755.00	34,111.00		24,524.00
16,593.00					
Business Expenses		69,712.00	75,148.00		67,120.00
47,266.00					
Net Income		14,322.00	48,085.00		24,008.00
8,850.00					
Income Reported	-0-	-0-	-0-	-0-	
Balance		14,322.00	48,085.00		24,008.00
8,850.00 ⁴					
Tax Due		1,182.20	4,558.50		2,150.80
635.00					

(b) Estate of Adolph Milich, Deceased

Year	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>		
Constructive Dividend		\$11,350.00	\$17,047.00	\$18,620.00	\$14,242.00	
Standard Deduction		(1,589.00)	(2,000.00)	(2,000.00)	(2,000.00)	
Exemption		(650.00)	(650.00)	(650.00)	(650.00)	
Net Adjustment		9,111.00	14,397.00	15,970.00	11,592.00	
Tax Due		397.46	805.73	957.00	531.54	

(c) Adolph Milich, Jr.

Year	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>		
Constructive Dividend		\$ 7,161.00	\$24,042.00	\$12,004.00		\$
4,425.00						
Statutory Medical Adjustment	-0-	-0-	322.00	-0-		
Net Adjustment		7,161.00	24,042.00	12,326.00		

⁴After allowance for minimum tax which was apparently paid on July 29, 1985.

4,425.00			
Taxable Income Reported	8,188.00	9,402.00	11,033.00
10,985.00			
Corrected Taxable Income	15,349.00	33,444.00	23,359.00
15,410.00			
Tax Due	563.62	2,834.16	1,307.26
382.00			

(d) Robert and Barbara Milich

Year	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>		
Constructive Dividend			\$ 7,161.00	\$24,042.00	\$12,004.00	\$
4,425.00						
Statutory Medical Adjustment	-0-			317.00	314.00	
132.75						
Unreported IRS Audit Change	-0-	-0-		6,475.00	-0-	
Net Adjustment			7,161.00	24,359.00	18,793.00	
4,557.75						
Taxable Income Reported			4,327.00	7,806.00	10,812.00	
9,503.00						
Corrected Taxable Income			11,488.00	32,165.00	29,605.00	
14,060.75						
Tax Due			425.96	2,790.10	2,232.70	
360.26						

SUMMARY OF PETITIONERS' POSITION

20. At the hearing, petitioners conceded that the only issue remaining to be resolved was whether the corporation was entitled to the aforementioned net operating loss deductions. They maintain that it was, since franchise tax reports were filed for said years showing such losses.

CONCLUSIONS OF LAW

A. That Tax Law § 208.9(f) provides, in pertinent part, that:

"[a] net operating loss deduction shall be allowed which shall be presumably the same as the net operating loss deduction allowed under [Internal Revenue Code § 172]".

B. That Internal Revenue Code § 172(a) provides, in pertinent part, that:

"[t]here shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year."

The statute and regulations pertaining to net operating loss deductions are complex and for the purposes of this determination it is sufficient to state that a valid net operating loss for any of the

years 1971, 1973 or 1974 would first be carried back to the three immediately preceding taxable years and, if not entirely absorbed by the income of those years, would be carried over for as many as five years following the loss year.

C. That petitioners have the burden of proof under Tax Law §§ 1089(e) and 689(e) to establish the net operating loss deductions. The only evidence introduced by petitioners at the hearing pertained to the preparation of the corporation franchise tax reports and Federal income tax returns for 1971, 1973 and 1974, which indicate that losses were incurred in said years. No other documentation or testimony was offered. Petitioners appear to be relying on the fact that said reports were accepted by the State and the statutory periods of limitation as to said years have expired.

D. That Tax Law §§ 1089(g) and 689(g) each provide as follows:

"Jurisdiction over other years. -- The tax commission shall consider such facts with relation to the taxes for other years as may be necessary correctly to determine the tax for the taxable year, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid."⁵

E. That the Audit Division is not barred from disallowing the purported net operating loss deductions for 1971, 1973 and 1974 despite the expiration of the statute of limitations on assessment for said years (Leitgen v. Commissioner, 42 TCM 1130). The Audit Division is entitled to recompute petitioners' income for the closed years in determining the deficiencies for the years at issue (Johnson v. Commissioner, 41 TCM 71).

F. That petitioners have not sustained their burden of proof. They failed to produce sufficient evidence, documents, business records or testimony to substantiate their claimed net operating loss deductions for 1971, 1973 and 1974 (Gregory v. Wood, 57-2 U.S. Tax Cas ¶ 10,006 [D Ariz 1957]; Moss Industries, Inc., 12 TCM 317).

G. That, except for the adjustments made pursuant to the Tax Appeals Bureau conference (Finding of Fact "19"), the petitions are denied and the notices of deficiency issued to the corporation on August 2, 1985 and the notices of deficiency issued to the Estate of Adolph Milich, Adolph Milich, Jr., Robert and Barbara Milich, and Robert Milich on August 8, 1985 are sustained.

DATED: Albany, New York
June 9, 1988

_____/s/_____
ADMINISTRATIVE LAW JUDGE

⁵Internal Revenue Code § 6214(b) authorizes the Tax Court of the United States to examine the validity of deductions resulting from losses in years for which the statute of limitations has expired, when redetermining income for other tax years under its consideration.